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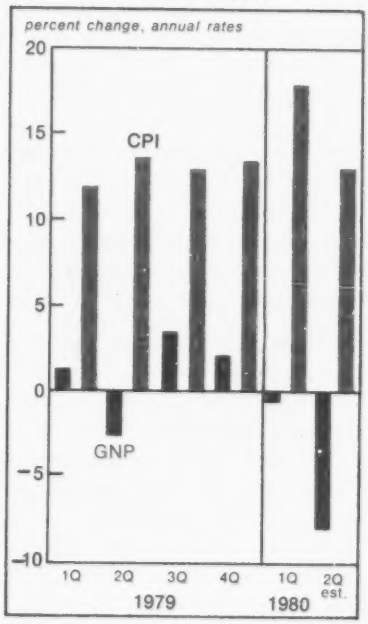
U.S. Recession Begins With a Bang

The long-awaited recession is clearly under way in the United States. Industrial production fell by a total of more than 2½% in March and April and the decline apparently continued in May. New orders for manufactured goods dropped 5.5% in April—the largest monthly reduction in more than five years. In one recent week, new claims for unemployment assistance set a record.

The recession apparently began in February. Housing construction and automobile sales had been weak for almost a year. But there had been enough strength elsewhere in the economy to permit slow growth in total activity. By late winter, however, the combination of extremely high interest rates and the effect of roaring inflation on real incomes finally began to reduce consumer spending for a broadening range of products. More recently, declining final sales apparently triggered a general move to reduce business inventories. Just in the past month or so, there has been an increasing number of reports of cutbacks in business capital spending programs.

U.S. real economic growth and inflation



This recession is somewhat unusual in that it involves an inventory adjustment early in the period of contraction; ordinarily, the inventory reduction comes much later, during the final process of adjustment that precedes recovery. This raises some hope that the current decline may be relatively brief; the most recent recession that involved an early inventory cutback was that of 1957-58, which was the shortest of the six post-World War II recessions. Regardless of duration, however, this downturn appears to have the potential of developing into quite a deep decline. According to some estimates, real GNP may fall during the current quarter by an amount greater than the total decline in three of the last six recessions.

Two other current developments should contribute to bringing about eventual recovery. One is the precipitous drop in interest rates. While fewer new housing units will probably be started in 1980 than in any other year since the war, lower interest rates promise the battered construction industry some relief by yearend. Even more importantly, the rate of price inflation has at last begun to abate. From about 18% in the first quarter, the annual rate of increase in the Consumer Price Index fell to 11½% in April. While there are bound to be several more bad months in the near future, the rate of price inflation should drop further as the year progresses.

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U.K. recession now underway, but monetary policy remains tight.

Recent statistics confirm that the long-awaited U.K. recession has now begun. The volume of retail sales is down 2.9% from its year-ago level, the index of industrial production is down 3.6%, and unemployment stands at 6%, versus 5.5% in January. Despite the slowdown, the balance of payments continues in deficit, registering a shortfall of £214 million in April for a cumulative deficit of £787 million so far this year. In addition, wage settlements show no sign of moderating. Average earnings in March were 20.1% above March 1979 levels. The Government is nonetheless sticking firmly to a restrictive monetary policy, and short-term interest rates stand at 17%. High returns for overseas investors have accordingly boosted the pound to a five-year high of 2.37 against the dollar, and have lifted the mark/pound rate back to 4.18. The financial markets expect the next move in U.K. interest rates to be downward, but opinion remains divided as to how soon the shift will occur. While the August-September period is most probable, a continued strengthening of the pound might force an earlier interest rate reduction.

Revised projections point to steeper Dutch economic growth slowdown.

Recent projections by the Dutch Central Planning Bureau suggest a gloomier economic outlook than previously forecast. On the external front, weaker economic growth prospects for Holland's trading partners will result in reduced demand for petroleum products, chemicals, and metals—items that constitute a large part of Dutch exports. Domestically, fiscal policy has been tightened. Public spending has been cut by an additional three billion guilders, and a restrictive incomes policy will hold real earnings this year to their 1979 level, implying a real decline for higher-income groups. As a result, inflation-adjusted consumption expenditure is projected to remain flat this year after rising 2.5% in 1979; industrial investment is expected to fall by 2% after rising 2% last year; and export volume growth will likely decline from 9.5% in 1979 to only 1% this year. Real GDP is thus expected to show virtually no growth in 1980, although the Dutch inflation rate will probably climb to 6% from 4.25% last year.

Mexico's new development plan projects rapid economic growth through 1982.

Mexico's recently released Global Development Plan for 1980-82 projects a continuation of the 8% real GDP growth posted in 1979. Relying on increased petroleum output and a high rate of public investment spending, the new Plan calls for more resources to be allocated to agriculture, rural development, transportation, and communications. These have been the only lagging sectors in an otherwise rapidly developing economy. The Plan also projects a high level of private investment spending over the next three years, with the total investment-to-GDP ratio likely to reach 27% by 1982. Job creation is a focus of considerable emphasis in the Plan, in view of the country's large number of unemployed and underemployed workers. With the availability of increasing petroleum revenues, the 1982 economic output goals of the new Plan should be attainable, but a satisfactory level of employment creation will probably take longer to achieve.

Philippine current account to be deeply in deficit in 1980-81.

Economic prospects for the Philippines are dimmed by the latest round of oil price hikes and by declines in domestic oil output and in world commodity prices. The current account is expected to show a deficit of $2.4 billion in 1980—large exports of sugar, copper concentrates, and gold will partly offset higher oil prices and declining world prices for coconut oil. And unless commodity prices improve, the deficit will widen to about $3.2 billion in 1981. Such deficits should prove manageable, however, given the high level and favorable terms of IMF and World Bank support. Long-term debt is expected to increase to approximately $11.5 billion by end-1981 from $7.9 billion as of end-1979, but the country's debt-service ratio should not exceed 20% and may actually decline slightly.

Uruguayan economic growth slowing from record rate in 1979

The Uruguayan economy achieved a record real GDP growth rate of 8.3% in 1979, a significant improvement over the 3% annual average advance of the 1973-78 period. Strong incentives to growth came primarily from the international sector. These consisted of higher meat export prices, strong earnings from tourism, and capital inflows from Argentina. There was also a boom in luxury and

resort residential construction, with sales almost entirely to Argentines. Modest investment in the manufacturing sector added to final demand, pushing the investment-to-GDP ratio to 24%, compared with 13.5% in 1978. So far this year, the economy has shown some weakness as a result of the combination of a 75% annual inflation rate affecting consumer demand and a cooling off of the construction boom. On balance, the rate of real economic growth in 1980 is expected to slow to 4%-5%.

Belgian current-account deficit widening, despite slow economic growth.

Poor European economic growth prospects are straining Belgium's export-dependent but structurally rigid economy. The country's current-account deficit has already increased dramatically, rising from $900 million in 1978 to $3.8 billion last year. Given an additional 60% jump in oil import costs and a weakening of exports, containment of the deficit in 1980 would require a substantial slowdown in domestic demand. The alternative of devaluation is not feasible for Belgium, which possesses a rigid system of wage indexation and a high import ratio—imports are equivalent to half of GDP. This leaves protection of the franc through high interest rates, an option that would hurt industrial investment. Belgium's external-account problem is compounded by the importance of exports of steel, chemicals, and textiles—industries sensitive to the global slowdown. In sum, despite the latest real economic growth forecast of only 1.5% for 1980, a widening current-account deficit is anticipated.

Liberia's export-dependent economy hurt by global recession.

Stagnation and growing dependence on foreign capital have characterized the Liberian economy throughout the 1970s, with the near-term outlook likely to be much the same. As one of the world's leading producers and exporters of iron ore, recessionary trends in the world steel industry have had a severe impact on both the domestic and foreign sectors of Liberia's economy. Export growth has not kept up with inflation, and real GDP growth has been increasing at a rate below that of population growth. Although the country's current-account deficit has narrowed from $138 million in 1977 to an estimated $75 million in 1979, the shortfalls have led to an increased dependence on foreign borrowing. With attempts at export diversification having met with only limited success, the unfavorable outlook for the world steel industry does not bode well for Liberian iron-ore exports, which constituted 54% of total exports in 1979. Similarly, the outlook for rubber, a source of 16% of export earnings last year, is less than encouraging because of the global recession. The uncertain economic outlook is further complicated by the unsettled political situation triggered by the April 12 coup.

Export credit costs set to rise slightly on July 1.

Last month, 22 OECD-member participants in an international accord on export credits agreed to a slight boost in minimum interest rates. Beginning July 1, lending rates on all categories of exports financed with government support will rise as follows: for "rich" and "intermediate" countries, rates on export credits of five years and over will climb to 8.75% and 8.5%, respectively, from their current levels of 8% and 7.75%; for "poor" countries, the rate will rise from 7.5% to 7.75%. The United States, Canada, and several other OECD members in favor of raising the current low minimums to market-related levels have accepted the small rate increase as only a temporary measure. A December 1 deadline has been set by which time several formulas for fixing minimum interest rates tied to movements in money-market rates will be studied. (Possibilities include having minimums vary among the lending countries in response to changes in government bond yields—with adjustments for currency differences—or periodic uniform adjustments in the current rate structure reflecting world money-market movements.) If no new formula can be achieved by December, the present accord may begin to disintegrate, raising the possibility of an export credit war among the industrialized nations. In the interim, U.S. officials will press the issue at the upcoming seven-nation economic summit in Venice and push for standby additional funding for the financially strained U.S. Export-Import Bank.

Federal Budget Balanced on a Tightrope

Soon after the Carter Administration unveiled its fiscal 1981 budget – which contained a $16-billion deficit – the U.S. Congress made efforts to balance it. Seeking to better the Congress, President Carter submitted a revised budget just two months later that showed a $16-billion surplus. However, events of the past few months have made any surplus all but unobtainable. Indeed, it is quite likely that the fiscal year 1981 budget will be substantially in deficit, despite the wishes of the President and Congress.

The pressure to increase defense spending sharply is one threat to a balanced budget. The first Congressional budget resolution–to have been passed on May 15 but still in dispute–sets overall targets for expenditures and receipts by broad categories. The shared determination to keep the budget at least nominally in balance has led to an extraordinarily divisive debate on how much increased defense spending can be accommodated. The House and Senate Budget resolutions are about $8 billion apart on the issue. It thus remains to be seen if this "guns *or* butter" policy, in contrast to the previous "guns *and* butter" policy, will help keep spending in check.

A more serious threat to a balanced budget stems from the extremely rapid deterioration of the economy in recent months. The Congressional estimates of receipts and expenditures are based upon forecasts made in March, when the unemployment rate was 6.2%. That forecast showed unemployment rising to 7.3% by yearend 1980 and to 7.6% by yearend 1981. But the April unemployment rate has already hit 7%, and it appears certain to move much higher in the coming months as the recession unfolds. Higher-than-expected unemployment will trigger increased spending for various income maintenance programs. And lower levels of business activity will lead to a shortfall in receipts, further increasing the probability and magnitude of a budget deficit.

The worsened economic outlook need not necessarily throw the budget off balance; non-recession-related spending could conceivably be cut. However, such cuts in expenditure would needlessly deepen the already-painful recession now under way. Indeed the recession's force has led to calls for tax cuts to ease the decline; this would clearly dash any hopes for a balanced budget in fiscal 1981.

Budgetary balance has acquired a certain symbolism in the public mind as an effective anti-inflation tool. But a budget deficit during a recession-plagued year–even allowing for a modest tax cut–should not necessarily be taken as a sign that Congress lacks the discipline to combat inflation. The real test will be whether the budget will be in balance–or in surplus–as the economic recovery takes hold.

Asia and Oceania — Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE O				
		3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use cre lions
Bangladesh	Improved political climate and relaxation of controls boost private investment significantly.	Jan.	+ 16%	8.9	$ 103	Apr.	338	– 7%	1.9	
Burma	Real GNP growth estimated at 6% for fiscal 1979/80, owing to favorable rice crop.	Jan.	+ 59%	4.3	128	Apr.	264	+ 80%	8.0	
China, People's Republic	Real economic growth expected to slow to 5.5% this year from 8% in 1979.	Mar.	+ 37%	515.0	510	June '79	3,538	+ 11%	3.0	
Hong Kong	A 27% increase in public expenditure will bolster economic activity this year.	Mar.	+ 36%	16.6	3,320	n.a.	—	—	—	
India	Tea output fell by more than 50% in first quarter, the result of poor weather.	Jan.	– 14%	121.1	188	Mar.	7,204	+ 3%	8.0	
Indonesia	Government boosts fuel prices by 50% in effort to reduce subsidy costs.	Dec.	+ 35%	43.4	289	Apr.	4,825	+ 53%	6.1	
Japan	Housing starts declined 0.8% in fiscal 1979/80 in response to higher mortgage costs.	Apr.	+ 23%	948.0	8,243	Apr.	18,246	– 28%	2.0	
Korea	First-quarter real GNP growth was 1.7%, compared with 13.1% in first-quarter 1979.	Mar.	+ 22%	64.1	1,624	Mar.	2,697	+ 1%	2.0	
Malaysia	Manufacturing output increase forecast at 8% for 1980, down from 10% in 1979.	Nov.	+ 41%	17.3	1,310	Feb.	4,008	+ 20%	5.7	
Nepal	Agricultural production forecast to rise 3% in 1980.	Dec.	– 7%	1.5*	114	Mar.	180	+ 16%	9.0	
Pakistan	Wheat output in 1980 expected to reach 10.8 million metric tons, surpassing official target.	Dec.	+ 46%	20.9	265	Apr.	886	+ 66%	1.9	
Philippines	Tight credit and fuel costs expected to cut 1980 manufacturing growth to 4% from 5.5% in 1979.	Mar.	+ 48%	29.1	612	Apr.	2,541	+ 31%	4.0	
Singapore	Domestic economy will be boosted by construction of $700-million petrochemical complex.	Jan.	+ 51%	8.9	3,708	Jan.	5,938	+ 12%	4.0	
Sri Lanka	Real GDP growth rate this year estimated to slow to 4% from 5% in 1979.	Dec.	+ 17%	3.1	206	Mar.	413	– 4%	3.8	
Taiwan	Output of heavy industry slowing this year because of rising fuel costs.	Mar.	+ 34%	27.6	1,623	Mar.	1,509	+ 5%	1.0	
Thailand	Budgeted government expenditure set to rise 16% in 1980.	Nov.	+ 25%	26.0	565	Apr.	1,729	– 19%	3.1	
Australia	Drought will severely curtail agricultural production this year.	Mar.	+ 35%	124.0	8,551	Apr.	1,692	– 22%	1.3	
New Zealand	Sheep production expected to increase 7% this year.	Mar.	+ 28%	15.4	4,812	Mar.	545	– 10%	1.0	

*1978

Asia

Oceania

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CD Funding More Attractive to Banks

While business loans at large banks fell by a massive $4 billion from mid-April to mid-May, there was virtually no decline in large "negotiable" certificates of deposit (CDs) outstanding over this period. At first glance this seems somewhat surprising, since business loans are often funded with CDs. But at least one reason for this unusual behavior is that the effective borrowing cost to banks of raising funds in the CD market since mid-April has been significantly below that of raising funds in the Eurodollar market. This has induced banks to increase the volume of CDs outstanding relative to their Eurodollar borrowings. At least one implication of this shift is that since a greater amount of reserves must be held against CD balances as against net Eurodollar borowings, the growth rates of both bank reserves and the monetary base have been greater than they would otherwise have been over the last few weeks.

For banks that are members of the Federal Reserve, reserve requirements against CD balances maturing in 90 days are eight percentage points greater than those applicable to Eurodollar borrowings of comparable maturity. Since these reserves yield no interest, the effective borrowing cost to banks at any given interest rate is about 8% greater in the CD market than in the Eurodollar market. Typically, the workings of the market result in 90-day Eurodollar rates being not too far from 8% above 90-day CD rates.

Since mid-April, however, 90-day Eurodollar rates have on average been more than 12% above 90-day CD rates. Based on the average level of interest rates prevailing during this period, this translates into an annualized effective borrowing cost differential of more than 40 basis points in favor of 90-day CDs.

This differential has led banks to increase CD balances relative to net Eurodollar borrowings. From mid-April to mid-May, net borrowings of large banks from their foreign branches fell by $4 billion. As it turns out, this decline was approximately equal to the drop in business loans.

While it is unlikely that this wide differential in borrowing costs will continue, its effects have had an impact on the behavior of various reserve measures. Since CDs have larger reserve requirements, a shift in bank liabilities into CDs and out of Eurodollars has resulted in an increase in bank reserves relative to total liabilities.

Moreover, since CDs are not included in the narrow monetary aggregates – M_{1a}, M_{1b}, or even M_2 – the growth of bank reserves and the monetary base has been faster relative to the growth in these monetary aggregates than would otherwise have been the case. And lagged reserve accounting implies that this effect on the growth in reserves relative to money supply growth may continue for at least two weeks—even if the borrowing cost differential disappears.

PAYMENTS		MONEY AND BANKING							COUNTRIES
IMF mil- lollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	domestic credit	central bank rate (June 4, 1980)	exchange rate in U.S. dollars (June 4, 1980)	current monetary conditions	
3	Government to receive $107 million in development aid from I.D.A.	Feb.	+18%	Jan.	+19%	—	.0650	Credit availability continues limited.	Bangladesh
8	Value of teak exports doubled in 1979 to $100 million.	Jan.	+ 3%	n.a.	—	—	.1510	Money supply grew 18% last year.	Burma
0	Volume of exports forecast to rise 11.5% in 1980, versus 26% in 1979.	n.a.	—	—	—	—	.7200	Bank of China to set up joint venture merchant bank.	China, People's Republic
—	First-quarter trade gap is 39% wider than year-earlier.	Mar.	+18%	Mar.	+43%	—	.2035	Prime rate decline buoys stock market.	Hong Kong
0	Crop failure necessitates import of 200,000 tons of sugar.	Feb.	+12%	Jan.	+23%	9.00%	.1290	Six largest private banks nationalized.	India
0	Rice imports to increase 40% this year.	Mar.	+21%	Nov.	+12%	—	.001630	Tax to be put on interest on foreign-currency time deposits.	Indonesia
0	Licensed imports in April were 68% greater than in April 1979.	Apr.	+ 8%	Feb.	+ 9%	9.00%	.004504	Long-term interest rates rise to 10.3%.	Japan
8	Current-account gap may hit $5 bn. this year, versus $3.9 bn. in 1979.	Mar.	+28%	Mar.	+41%	21.00%	.0018	Large foreign borrowings will boost money supply growth.	Korea
0	Government to impose 25% export tax on oil.	Mar.	+ 6%	Feb.	+15%	—	.4635	Prime rate holds steady at 7.5%.	Malaysia
1	Earnings from tourism increased 25% last year.	Jan.	+15%	Dec.	+23%	—	.0855	Large fiscal budget increases money supply growth.	Nepal
4	U.S. to provide trade concessions on textiles.	Mar.	+10%	Jan.	+24%	10.00%	.1020	Credit restrictions maintained.	Pakistan
9	Trade deficit reached $724 million in first quarter.	Apr.	+19%	Feb.	+24%	4.00%	.1365	Credit conditions continue restrictive.	Philippines
0	March trade deficit a record $349 million, owing to heavy imports.	Feb.	+ 9%	Dec.	+28%	—	.4685	Prime rate dips to 11.75% from 12%.	Singapore
7	Textile export growth threatened by possibility of foreign quotas.	Dec.	+15%	Nov.	+42%	10.00%	.0665	Credit restrictions maintained.	Sri Lanka
0	Foreign investment in Jan.-Apr. was 54% above year-earlier level.	Mar.	+17%	Feb.	+19%	14.00%	.0290	Money supply grew 13% in March.	Taiwan
8	Export target of $6.8 billion set for 1980.	Dec.	+15%	Oct.	+28%	14.00%	.0505	Credit conditions remain restrictive.	Thailand
1	Commodity exports remained strong in first quarter.	Dec.	+10%	Jan.	+16%	—	1.1470	Restrictive monetary policy maintained.	Australia
3	Overall payments deficit rose to $482 million in fiscal 1979/80 ended March.	Dec.	+17%	Mar.	+18%	13.00%	.9840	Bank deposit growth was 18% in fiscal 1979/80.	New Zealand

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World Interest Rates

market rates of June 4, 1980; bond yields as of May 30, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	11.83	17.00	14.00	9.50	7.50	15.00* penalty rate 18.00	10.00	3.00	9.00
Day-to-Day Money	9.75 June 5	15.00	15.50	13.65	12.3125	9.50	16.875*	11.25	5.00	12.875
Treasury Bills 91-day, Middle Rates	7.27	11.60	16.00	15.10	n. a.	n. a.	14.75* 92-day	no dealing	no market	6.75 2-month
Commercial Paper prime, 3-month, asked	8.00 finance paper	12.00 finance paper 15% tax w/h	14.76	13.90 Certified	12.50 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.50	11.80 15% tax w/h	16.3125	15.00 Certified	not traded	10.30	19.00*	no market	4.50 not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.31	11.80	13.69	10.44 20% tax w/h	12.86	8.34	15.08*	9.96	4.82	8.25
Industrial Bonds prime, long-term, new and old issues, average yield	11.05 Aa Industrials	12.25	14.39	13.95	13.87	8.53	15.04*	10.83	5.68	7.50
Bank Short-Term Rate to Best Borrowers (prime rate)	13.00	13.75	18.00	18.75	14.60	11.50	20.00*	13.00	5.50	9.25
Bank Time Deposits 3-month	8.50 Cert. of Dep.	12.00 Cert. of Dep.	16.875	15.15	12.5625	10.05	10.75*	11.25 large deposits	5.50 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	9.9375	no market	16.75	no market	12.50	9.50	no market	10.875	5.6875	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8642	2.3170	.03500	.2417	.5620	.001202	.5113	.6055	.004495
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.45 *D*	6.70 *D*	5.15 *D*	2.50 *D*	.50 *P*	8.89 *D*	1.15 *D*	4.45 *P*	2.00 *D*

Eurodollar Deposits
(London, interbank, bid)
June 5

7-day	9.5625
1-month	9.75
3-month	9.75
6-month	9.75

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.81
U.S.-Canada Treasury Bills	−2.40
U.S.-Canada Finance Co. Paper	−2.14
Eurodollars-U.K. Local Auth. Deposits	− .12

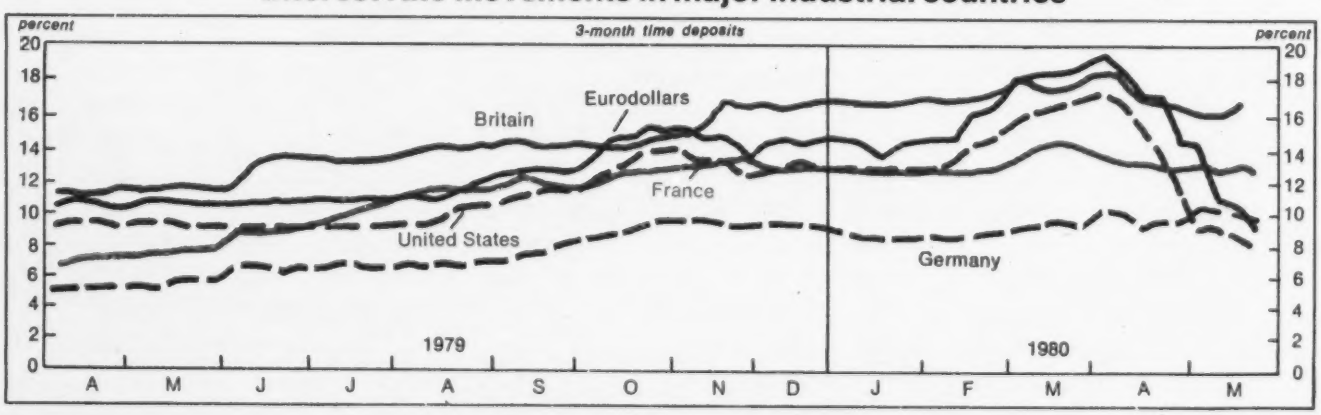
Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.375
Over 7 yrs.	11.125
DM Bonds	
7 yrs. and under	8.875
Over 7 yrs.	8.875

Gold Price
London afternoon fixing
571.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Market rates as of May 28; bond yields as of May 23.

Interest rate movements in major industrial countries



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Venezuela Poised for Steady Expansion

When Luis Herrera Campins assumed the presidency of Venezuela in March 1979, the country's fiscal and foreign-payments position was in considerable imbalance. The heavy government spending of the 1975-78 period, designed to speed up economic development and reduce dependence on oil, had adversely affected Venezuela's internal and external accounts. In 1978, the fiscal deficit approached 6% of GDP—a sharp contrast to the budget surpluses prevailing prior to 1977. Similarly, the current account of the balance of payments shifted from a surplus equal to 8% of GDP in 1975 to a deficit of 14% in 1978. The need to finance these deficits through external borrowing and reserve depletion expanded the Government's foreign debt burden from about $2 billion in 1975 to $14 billion at yearend 1978, while over the same period international reserves declined from $8.4 billion to $6.4 billion.

Since early 1979, however, the combination of sharp petroleum price increases and more conservative demand-management policies have arrested these deteriorating trends. And it appears as if this favorable combination of influences will continue to have a positive impact on the Venezuelan economy in the medium term.

Last year saw a shift to conservatism

On the fiscal front, progress toward a balanced budget was made last year largely by holding expenditures to their 1978 level of $11.5 billion, rather than through increases in income or sales taxes. This helped reduce the central government deficit to a low of 1% of GDP in 1979. In the last several months, government revenues have increased, owing to higher world oil prices, and it is estimated that the budget was brought into balance during the first half of 1980.

A restrictive monetary policy accompanied the conservative fiscal stance last year. The authorities slowed the growth of domestic liquidity to curtail the expansion of private demand and thereby reduce pressure on prices and imports. The growth of the monetary aggregates decelerated to rates of less than 10% during most of 1979 from rates in excess of 15% in the previous year. Indeed, during most of 1979, despite declining international reserves, the growth of domestic credit to the private sector was held at a rate no higher than that of 1977-78. In the past six months, however, the rise in oil export earnings has led to a renewed infusion of liquidity into the banking system. International reserves are currently $6.8 billion, up sharply from a low of $5.2 billion in August 1979.

An inevitable consequence of last year's contractive demand-management policies was a slowdown in the expansion of overall economic activity. Real GDP is estimated to have advanced about 3% in 1979, versus 4.8% in 1978. But even this expansion was mainly the result of a temporary increase in oil production, as non-petroleum sectors recorded either limited gains or actual declines in output. In the wake of the Iranian shortfall, Venezuela increased crude oil production by almost 9% to 2.36 million barrels per day.

Statistics for the first quarter of 1980 indicate that the economy continues to be depressed. Automobile and cement sales, reliable indicators of industrial and construction activity, dropped 17% and 6%, respectively, below their previous year's level. And petroleum production is also down—in contrast to its upsurge a year ago—currently standing at 2.1 million barrels per day, compared with 2.3 million in May 1979.

Despite the more restrictive fiscal and monetary stance, inflation accelerated in the last quarter of 1979. On a year-over-year basis, it reached 20.5% in December, compared with 7% a year earlier. The main cause was the removal of price controls on a large number of items, which was followed by legislated increases in salaries. In the first quarter of 1980, inflation remained around 22% on a year-over-year basis, but the monthly increments began decelerating because of the absence of additional cost-push factors.

A turnaround for the external accounts

Last year's restrictive policies and higher oil prices had a favorable impact on Venezuela's external accounts. Import expenditures remained at the same level as in 1978—$11 billion—which meant a substantial decline in real terms. On the export side, the oil shortage precipitated by the Iranian revolution set the stage for a sharp rise in the average price of Venezuelan oil from $12 per barrel in 1978 to more than $17 last year, and for a jump in the volume exported of 110,000 barrels daily to 2.1 million barrels per day. Consequently, export receipts soared 50% to $13.8 billion, and the trade balance, which posted deficits in 1977 and 1978, shifted to a surplus of $2.8 billion in 1979. Despite further deterioration in the services and transfers account, a result of higher interest payments on the larger external debt, the current-account deficit shrank from a peak of $5.4 billion in 1978 to $1.5 billion. Foreign borrowing by the private and public sectors—most of the external funds obtained by the Government and its agencies was short term—was sufficient not only to cover the current-account deficit, but also to allow for $1.3 billion in reserve accumulation.

Venezuela Poised for Steady Expansion *(continued from page 7)*

Venezuela's external payments position has continued to improve during the first half of 1980. Import demand has remained depressed, while export earnings have increased along with the rise in oil prices to their current weighted average of about $27 per barrel. In fact, it is estimated that the current account is now in surplus—for the first time since early 1976.

Oil windfall creates new options

Venezuela's balance-of-payments turnaround affords the authorities an opportunity to see through the completion of various projects begun by the previous administration and to address various unmet social needs. The uncompleted projects were launched by the Government after the 1973 oil price explosion, and were aimed at industrializing and diversifying the economy, achieving self-sufficiency, and improving export prospects. Most of the investments were concentrated in a few basic industries (e.g., steel and aluminum) as well as in infrastructure. (The oil sector did not benefit from the investment boom; indeed, insufficient exploration and a conservation objective were responsible for a cut in oil production from 3 million barrels per day in 1974 to 2.2 million by 1978.) However, shortages of skilled manpower and building materials, cost overruns, and instances of waste and corruption hindered the completion of several of the major projects.

While the new petroleum bonanza has essentially eliminated the need for haste in Venezuela's diversification effort, and has made available new funds for investment purposes, the Herrera Administration has decided to proceed cautiously. Emphasis will apparently be placed on curbing mismanagement within the public sector generally, and within the emerging industries in particular, as well as on investment in the petroleum industry and in low-income housing.

The renewed interest in the petroleum sector was reflected in a massive $25-billion, ten-year investment plan launched last year. The program's obectives are to increase productive capacity to 2.8 million barrels per day, locate more light and medium crudes, upgrade refinery capability to produce more gasoline, and develop the Orinoco Heavy Oil Belt into a commercially viable source of crude. At present, Venezuela possesses about 18 billion barrels of proven petroleum reserves, enough to sustain another 22 years of output.

The Herrera Government has also taken steps to stimulate private-sector investment. In recent years, the local business community has become increasingly uncompetitive because of the protection afforded by high tariffs and the absence of new foreign ventures in the country. Moreover, business has been hindered by an unfavorable investment climate attributable to government interference in pricing and in other management decisions.

It is in an effort to stimulate producers that the authorities lifted many price controls and began to open up domestic markets to external competition through tariff reform. The success of these measures hinges primarily on the Government's willingness to continue with its price decontrol program despite the inevitable short-run inflationary effects and the opposition from organized labor. The plan's favorable impact on resource allocation also depends on tariffs being lowered well below their current level of more than 100%.

Medium-term outlook

The improved external-payments and fiscal-revenue situation is likely to lead the Venezuelan authorities to pursue a more expansionary set of monetary and fiscal policies that will foster a reactivation of the economy. GDP growth may well begin accelerating during the second half of this year, with industry and construction leading the economic recovery. Only the petroleum sector is anticipated to register an absolute decline, as oil production will be kept at least 10% below last year's level.

The outlook for 1981-82 depends to a large extent on how rapidly the Venezuelan Government spends its second oil windfall. If social, regional, and other pressures are such that the authorities embark on a new spending spree, the result will be a high rate of economic growth accompanied by rapid inflation and a quick return to current-account deficits. If, on the other hand, the Government holds firm to its stated objectives of rejecting new ambitious industrialization projects, completing investment programs already under way, and providing greater incentives to private-sector capital formation, Venezuela's development will proceed at a less rapid, but more orderly, pace. This would mean real GDP growth averaging approximately 5% during 1981-82, and an inflation rate declining to the 10%-15% range. Since import demand will probably not rise at the excessively high rates of 1974-78, while oil prices will likely continue to increase in real terms, the country's current account should not register a deficit any larger than 2% of GDP by 1982. This would permit the Venezuelan authorities to reduce the burden of the country's external indebtedness both by minimizing its growth and by improving its maturity profile.

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